

April 13, 2015

The Honorable John Thune
Co-Chair, Business Income Tax
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Benjamin Cardin
Co-Chair, Business Income Tax
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Senators Thune and Cardin:

Farm Bureau supports replacing the current federal income tax with a fair and equitable tax system that encourages success, savings, investment and entrepreneurship. We believe that the new code should be simple, transparent, revenue-neutral and fair to agricultural producers.

We commend the Committee on Finance on its methodical approach to tax reform by forming working groups to review current law and to solicit input from stakeholders. The American Farm Bureau Federation (Farm Bureau) is the nation's largest general farm organization, representing agricultural producers of nearly every type of crop and livestock across all 50 states and Puerto Rico. We appreciate the opportunity to submit comments about the farm and ranch business taxation to the Business Income Tax Working Group.

Pass-through Businesses

Any tax reform proposal considered by Congress must be comprehensive and include individual as well as corporate tax reform.

The most common form of farm ownership is sole-proprietor which accounts for 86.7 percent of all farms and 50 percent of sales. Partnerships comprise 6.5 percent of farm operations and 22 percent of sales. Incorporated farms, both C-corps and S-corps, comprise 5.1 percent of farms but account for 22 percent of sales with the vast majority of these farm corporations being family-held. In total, more than 96 percent of farms and 75 percent of farm sales are taxed under the provisions of the Internal Revenue Code (IRC) provisions affecting individual taxpayers. (USDA 2012 Census of Agriculture).

Because many business deductions and credits are used by both corporate and pass-through businesses, their elimination in exchange for corporate-only rate reduction will result in a tax increase for the vast majority of farmers and ranchers who pay taxes as individuals. One example is the domestic production expense deduction, which amounts to an average \$8,926 deduction per eligible farm household. (USDA Economic Information Bulletin Number 107, February 2013). Thus, any tax reform proposal that fails to reform the tax code for pass-through businesses will not help, and more likely hurt, the bulk of agricultural producers.

The loss of business tax deductions could also disadvantage family farm businesses that operate as C-corps because they tend to be small and already pay taxes on the lower side of the corporate rate scale. Just as with non-incorporated farms and ranches, they would be hurt by the loss of deductions but would not benefit completely from reduced corporate tax rates. In particular, the 15 percent bracket for corporations with taxable income up to \$50,000 should be retained and expanded, so that the income level is indexed for inflation using 1986 as a base.

Effective Tax Rates

Any tax reform plan that lowers rates by expanding the base should reduce the tax burden of farm and ranch businesses.

While broadening the base and lowering the tax rate is important to any tax reform effort and is supported by Farm Bureau, it must be noted that lowering rates will impact farm and ranches differently than other businesses. Due to the effects of unpredictable weather on crop yields and uncontrollable markets on the price of goods sold, taxable income for farmers and ranchers can be highly variable. In fact, it is not uncommon for farmers and ranchers to have years with little or no taxable income. For example, USDA reports that based on IRS data, nearly three of every four farm sole proprietors reported a farm loss in 2010. About half of farm partnerships and small business corporations also reported losses. (USDA Economic Information Bulletin 107, February 2013.) Thus, a lower rate alone may not adequately compensate farmers for lost tax provisions and over time could result in a higher effective tax rate.

Cash Accounting

Cash accounting is the preferred method of accounting for farmers and ranchers because it provides the flexibility needed to optimize cash flow for business success, plan for business purchases and manage taxes.

Cash accounting allows farmers and ranchers to improve cash flow by recognizing income when it is received and recording expenses when they are paid. This gives them the flexibility they need to plan for major investments in their businesses and in many cases provides guaranteed availability of some agricultural inputs. Accrual accounting complicates farm and ranch management and takes away the flexibility needed to deal with uncontrollable weather and unpredictable markets. For example, under accrual accounting the costs associated with the growing of crops and raising of livestock can't be expensed when they are incurred but instead must be accumulated to be deducted only when the commodity is sold.

Under a progressive tax rate system, farmers and ranchers, whose incomes can fluctuate widely from year to year, will pay more total taxes over a period of time than taxpayers with more stable incomes unless they are allowed to take advantage of tax tools to even out taxable income. Cash accounting gives farmers and ranchers the flexibility to manage their tax burden on an annual basis by controlling the timing of both revenue and expenses so as to balance them out at an optimum level of income for tax purposes. Loss of cash accounting could create a situation where a farmer or rancher could have to pay taxes on income before receiving payment for sold commodities. Not only would paying the tax become difficult, but cash flow problems could

necessitate a loan to cover ongoing expenses until payment is received. The use of cash accounting helps to mitigate this challenge by allowing farm business owners to make tax payments only after they receive payment for their commodities.

Many farms and ranches do not employ professional accountants or bookkeepers; instead family members maintain financial records. The loss of cash accounting would require extra bookkeeping, including but not limited to tracking inventory, accounts receivable and accounts payable. Given that agricultural operations run on thin margins and are “price takers” unable to pass on added cost to their customers, any impact of increased administrative expenses could have a significant impact on farm profitability.

While some industries with a high level of gross receipts are able to absorb the impacts of accrual accounting, this is not true for agricultural businesses. Because farms and ranches typically have high input costs, a high level of gross receipts does not necessarily translate into profitability. Gross receipts thresholds that trigger accrual accounting are problematic because high commodity prices, inflation and other market conditions could cause a farm operation to alternately surpass and then dip below the threshold on a year by year basis. In addition, IRS aggregation rules could faultily require a farm and ranch business to switch to accrual accounting because multiple related businesses must combine their income when calculating gross receipts. Agricultural operations are often divided into several related businesses that when aggregated could exceed an accrual threshold, causing each of the related businesses to use the accrual method even though they would not have to do so independently.

Under current law only C-corp farm and ranch businesses with over \$25 million of gross receipts are required to use accrual accounting. Any change that forces an agricultural operation to switch from cash to accrual accounting will have negative financial consequences, add complexity to the financial management of farm and ranch businesses, and diminish the management flexibility that is so critical to success in volatile agricultural markets. Farm Bureau supports the continuation of unrestricted cash accounting for farmers and ranchers so that farm and ranch businesses have the flexibility they need to optimize cash flow for business success, plan for business purchases and manage their tax burden.

Accelerated Cost Recovery

Because production agriculture has high input costs, farmers and ranchers place a high value on expensing equipment and supplies and the deductibility of preproductive expenditures.

Immediate expensing helps farm and ranch businesses remain profitable and competitive by allowing them to continually replace and upgrade farm equipment, buildings, and storage facilities. As a result, they are able to reduce maintenance costs, take advantage of labor-saving advances, become more energy efficient and adopt technology that is environmentally friendly. When farmers and ranchers have good years, expensing provisions help them to maximize their after-tax income to allow for a higher level of supply and equipment purchases. This averages out against the poor years when they don’t have money available to invest, helping them to keep their businesses efficient and sustainable in the long term.

By helping farmers and ranchers better manage cash flow, tax provisions that accelerate deductions also help farmers reduce borrowing needs. Immediate expensing allows farmers and ranchers to cash flow purchases that otherwise would be impossible to make or that would require them to incur debt expense when purchases cannot be delayed. In addition, the ability to immediately expense capital purchases offers the benefit of reducing the record keeping burden associated with the depreciation of that capital over the years of its useful life.

Section 179 small business expensing allows a taxpayer to deduct all of the cost of new or used business property rather than depreciating the cost over a longer period of time. Qualifying property must be used in an active trade or business like farming and ranching. For 2014, the maximum deduction was \$500,000 of purchased business property reduced dollar-for-dollar when investments exceeded \$2 million. Unless extended, the deduction for 2015 will be \$25,000 with the deduction reduced dollar-for-dollar when expenditures exceed \$800,000.

According to USDA Economic Research Service farm sector balance sheets for 2015, machinery and motor vehicles currently make up 9.1 percent of farm assets. Because farmers and ranchers have high input costs and must buy expensive equipment, Farm Bureau supports maintaining or expanding the \$500,000 Sec. 179 small business expensing limitation and not reducing the \$2 million acquisition limit with both indexed for inflation.

When a farm business makes a major purchase, for example, a combine for up to \$500,000 or a tractor for \$250,000, business expenditures will spike and can easily reach the small business expensing threshold. Fifty percent bonus depreciation allows a taxpayer to deduct up to half of the cost of new-only business property above what would normally be deductible. While most farmers and ranchers use Section 179 small business expensing, bonus depreciation gives larger operations exceeding expensing limits a way to upgrade and modernize their equipment. Bonus depreciation expired at the end of 2014 and should be made permanent.

Farm Bureau also supports allowing farmers to: immediately expense soil and water conservation expenditures; deduct the cost of raising dairy and breeding cattle; immediately expense fertilizer and soil conditioner costs; deduct the cost of raising timber; depreciate single purpose ag structures over shorter lives; deduct the cost of endangered species recovery; and deduct reforestation expenses. Of these expenses, the immediate deductibility for fertilizer and soil conditioners is by far the most widely used farm and ranch business deductions. Research from the Agriculture and Food Policy Center at Texas A&M University also clearly suggests that loss of this deduction would have the greatest negative impact on crop farmers of any recently proposed tax code changes.

In low income years, allowing an unused deduction or credit to be carried backwards can provide an immediate benefit while carrying forward provides a delayed benefit. To accommodate the unpredictable nature of farm income, Farm Bureau recommends that farmers and ranchers be allowed to apply the tax benefits of excess deductions and credits to previous and/or future tax years and supports the five year carry-back operating loss deduction for farmers and ranchers.

Other Provisions that are Important to Farmers and Ranchers

Like Kind Exchanges (Section 1031)

Capital gains taxes and in some cases, ordinary income tax, on the sale of business property can be deferred if a farmer or rancher purchases replacement property of a like-kind (Section 1031 exchanges). When farmers sell land or equipment and do not acquire like-kind property they recognize gain and pay the deferred tax. There is rationale for allowing property owners to defer taxes on asset transfers when they continue their investment in like-kind assets. Without Section 1031 like-kind exchanges some farmers and ranchers would need to incur debt in order to continue their farm or ranch businesses or worse yet, delay much-needed improvements to maintain the financial viability of their farm or ranch.

There are many reasons that farmers and ranchers use Section 1031 like-kind exchanges for land and buildings. They may want to consolidate distant land parcels into a contiguous unit to reduce the time and money they spend moving equipment, specialized structures, supplies and commodities from one place to the other. They may want to consolidate crop land closer to livestock barns, crop storage facilities, equipment sheds or the homestead where they live. They may use like-kind exchanges to obtain more productive cropland or to mitigate environmental impacts. Or they may want to move their farm or ranch businesses out of the path of urban development to a more rural setting.

Farmers and ranchers may also use like-kind exchanges to reconfigure their businesses so that young or beginning farmers can join the business. They may use Section 1031 like-kind exchanges to trade in used farm equipment and farm vehicles for newer models that are more fuel efficient, more technologically advanced or mitigate labor needs. Livestock exchanges may be used to relocate livestock businesses, acquire younger animals, and/or improve the genetic diversity of herds. Like-kind exchanges involving single purpose agricultural or horticultural structures are important to farmers and ranchers wanting to replace or upgrade structures like greenhouses and buildings used to house animals.

Farm Bureau supports allowing farmers to defer taxes when exchanging farm property for farm property (Section 1031 like-kind exchanges). Farm Bureau also supports increasing the time allowed to identify exchange property from 45 days to six months and the time allowed to close and receive property from six months to one year.

Domestic Production Activities Deduction (Sect. 199)

Non-corporate entities paying taxes under the individual income tax system as sole proprietors, partners and other pass-through entities are able to benefit from the Section 199 deduction that encourages domestic production and production-related activities. As domestic producers of food, fiber and fuel, farmers and ranchers are eligible. A farmer-owned cooperative (Subchapter T) may calculate the deduction based on its wages and then pass it through to its members on a patronage basis.

The Section 199 deduction is limited to the lesser of 9 percent of adjusted gross income or domestic production activities income or 50 percent of wages paid to produce such income.

Restricting the deduction to 50 percent of wages paid limits applicability to farmers and ranchers who produce labor-intensive commodities such as fruits, vegetables and milk. It also rules out smaller agricultural operations that use only family labor to grow or produce agricultural products. In fact, America's farmers and ranchers produce more than \$400 billion worth of food, fiber and fuel annually with only 22 percent of operations employing farm workers. Even with these limiting factors, IRS tax data shows approximately 7 percent of farm households directly benefit from the deduction. While the wages-paid limitation reduces the deduction for many smaller farms that hire little or no labor, farm sole proprietors deducted nearly \$1.25 billion in 2010. In addition, the average deduction for eligible farm households was \$8,926. (USDA Economic Research Service, Economic Information Bulletin 107, February 2013).

Reducing or eliminating the domestic activities deduction would result in a significant increase in taxable income for all farms that currently employ non-family labor. On the other hand, the benefit of the deduction would increase if agricultural producers were able to count non-cash wages paid, such as crop share payments of commodities, and wages paid to their children working on their farms.

Self-Employment Taxes

The vast majority of farmers and ranchers are self-employed and as such are able to take a 100 percent deduction for the health insurance premiums they pay against their income taxes. According to the USDA Economic Information Bulletin Number 107, February 2013, the average deduction for farm families using the deduction amounts to \$6,173. Farm Bureau supports continuation of this deduction and recommends that it be expanded so that a deduction can also be taken against self-employment taxes.

Farm Bureau believes that Conservation Reserve Program payments are rental income rather than earned income and therefore should not be subject to self-employment taxes. Likewise, rental income from land leased to the owner's family farm corporation, Limited Liability Company or partnership is not earned income and should also be exempt from self-employment taxes.

Income Averaging

An important tool that farmers and ranchers use to reduce income swings and to manage tax liabilities is farm income averaging. In 2004, according to IRS tax data, 50,800 farmers reduced their tax liability on average by \$4,434 with income averaging. (USDA Economic Information Bulletin Number 107, February 2013). This provision would be even more valuable to farmers and ranchers if the averaging period were extended. Farm Bureau recommends that farmers and ranchers be allowed to average income over a five year period instead of the current three year period, that share-based rental income be eligible for income averaging, and that farmers and ranchers be given the flexibility to determine how much eligible farm income to assign to a specific prior year.

Land Installment Sales

A land purchase option that benefits both the buyer and seller of farmland is the installment sale. An installment sale provides sellers with an income flow over a number of years and may allow

them to be in a lower tax bracket. An installment sale is attractive to a buyer because it allows the opportunity to secure financing and make payments over a period of time at possibly lower interest rates than what would be commercially available. Young and beginning farmers find installment sales especially attractive because they typically have a limited amount of cash to put down and, thus, face more challenges in obtaining financing. Farm Bureau supports the continued availability of installment sales for farm property.

Farmers and ranchers pay a disproportionate amount of their income in property taxes because the value of their business is land-based and thus more subject to the real property tax than other businesses and individuals. Because the size of a real property tax bill is based on the value of the land owned and not the amount of money earned on that land, it is not linked to the landowners' ability to pay. This can create special hardships for farmers with land but relatively low cash flow. For this reason Farm Bureau supports the continuation of the deduction for local and state property tax paid on business assets and income.

UNICAP Rules for Plants

Uniform capitalization (UNICAP) rules are complex and a record keeping burden for those who grow perennial crops and plants for resale. A grower must include certain direct and indirect costs in the basis of property and then recover these costs through depreciation or at the time of sale when there is a preproductive period of more than two years. Farm Bureau supports excluding all plants from the UNICAP rules. In addition, farmers and ranchers should be allowed to use the same depreciation methods as other taxpayers. In 1987, in a compromise allowing producers of livestock an exception from UNICAP requirements, all farm producers were restricted from using the 200-percent declining balance method of depreciation. With elimination for the vast majority of farmers, the policy reason for limiting farm depreciation methods is moot.

Donated Food

Some farmers and ranchers already donate gleaned food to charity. Many more would do so if they were able to bear the costs of harvesting, processing and transporting surplus food. Unfortunately, when growers can't afford the expense of getting food from the field to the food bank, all too often it is left in the field or orchard. Farm Bureau believes the provisions that allow non-C corporations to take a deduction for donating food should be made permanent and the deduction should be expanded so that farmers who use cash basis accounting could also take advantage of the deduction. The current deduction expired at the end of 2014.

Donated Conservations Easements

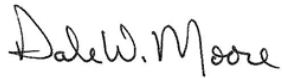
The enhanced deduction for donating conservation easements to preserve farmland is of interest to farmers and ranchers. The current deduction has been temporarily expanded to raise the maximum deduction a donor can take for donating a conservation easement and to increase the number of years over which the deduction can be taken. More farmland owners would be willing to protect their farmland from development if the deduction is made permanent and if they are able to take a deduction akin to the reduced value of their property. The current deduction expired at the end of 2014.

Summary

Farm Bureau greatly appreciates your consideration of our views on farm and ranch business taxation. We would be glad to meet with members of the Business Income Tax Working Group to provide additional information or to discuss our position in greater detail.

Note: This statement is not a complete list of Farm Bureau tax priorities. Statements have been filed with other working groups on estate taxes, capital gains taxes, and tax incentives for renewable energy.

Sincerely,

A handwritten signature in cursive script that reads "Dale W. Moore".

Dale Moore
Executive Director
Public Policy